BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	)	MM Docket No. 93-215
and	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

REPLY COMMENTS OF TELE-COMMUNICATIONS, INC.

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August 1, 1994

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SUMMARY

The record in this proceeding demonstrates that the interim cost-of-service rules should not be made permanent. The Commission's wholesale adoption of traditional common carrier regulation into the cable industry is not only contrary to the Cable Act but is also unwise as a policy matter.

In particular, the Commission should not restrict the use of prevailing company pricing for affiliate transactions. Unlike in telephony, there is no history or evidence of abuse in valuing affiliate transactions to warrant a restriction on prevailing company pricing. In this regard, TCI strongly supports the analysis of Michael A. Salinger demonstrating that the use of prevailing company pricing is much easier to implement, provides incentives for continued cable operator investment in cable networks, and encourages price reductions in programming.

In addition, TCI strongly objects to the imposition of a productivity offset to cable. In arguing for "regulatory parity," the telcos grossly overstate the degree of competition between the cable and telephone industries. Moreover, arguments in support of a productivity offset and, in particular, the declaration of Robert G. Harris, are fundamentally flawed.

Finally, the Commission should be aware that cost-of-service regulation is exceptionally burdensome and costly for cable operators, the Commission, and local franchising authorities to implement. All of the expense and time devoted to these efforts reflects lost opportunities for customers and ratepayers.

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Tele-Communications, Inc. ("TCI"), by its attorneys, files these reply comments in response to the Further Notice of Proposed Rulemaking in the above-captioned docket.

I. INTRODUCTION

The comments filed in this proceeding on July 1, 1994, demonstrate that the interim cost-of-service rules should not be made permanent.[1] As the record illustrates, the Commission's wholesale adoption of traditional common carrier regulation into the cable industry is contrary to the Cable Act. The rigid and formulary interim cost-of-service rules also are at odds with the backstop function of cost-of-service regulation and fail to account for the transitional nature of cable rate regulation.

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[1] See, e.g., Comments filed by Time Warner, Comcast, Continental, Falcon Cable Television, NCTA, and Viacom.

In lieu of the proposed rules, the comments support a flexible, ad hoc approach that is based primarily on the presumptive acceptance of a cable operator's audited historical books and records. Since these books are kept in accordance with Generally Accepted Accounting Principles, local franchising authorities and the Commission will be able to effectively assess the reasonableness of a cable operator's cost-of-service filing.[2]

In these reply comments, TCI focuses on three specific points: (1) the proposal to restrict the use of prevailing company pricing for affiliate transactions; (2) the inapplicability of telephone productivity offsets to cable; and (3) the extraordinary costs, resources, and effort required to file cost-of-service showings under the interim rules.

II. THE COMMISSION SHOULD NOT RESTRICT THE USE OF PREVAILING COMPANY PRICING FOR AFFILIATE TRANSACTIONS

The comments demonstrate that regulation of affiliate transactions, and more specifically, limiting the use of prevailing company pricing, is unnecessary and detrimental to subscriber interests. Persuasive evidence has been provided that prevailing company pricing is a reasonably reliable measure of fair market value for most transactions that occur between cable affiliates.[3] Further, unlike in telephony, there is no history

[2] See, e.g., TCI Comments at 25-32; Falcon Cable Television Comments at 4-11.

[3] See TCI Comments at 45-50; Time Warner Comments at 22-28; Turner Broadcasting System Comments at 11-14.

or evidence of abuse in valuing affiliate transactions to warrant a restriction on the use of prevailing company pricing.[4] In fact, where transactions involve the purchase and sale of programming, there is every incentive for programmers to maintain low prices for affiliates in order to reach the widest possible distribution.[5] Thus, the interim affiliate transactions rules are more than adequate to protect consumers against manipulative pricing.

Included with Turner Broadcasting System's comments are two studies by Michael A. Salinger examining the impact of the Commission's proposal to restrict the use of prevailing company pricing on the cable industry. TCI strongly supports Salinger's analysis.

Salinger demonstrates that it will be far more difficult to value affiliate transactions if the Commission severely restricts the use of prevailing company pricing.[6] Since the Commission's rules propose to value most asset transfers at the lesser of cost and fair market value, two distinct estimations must be made -- one regarding fair market value and the other regarding cost. As Salinger shows, to estimate fair market value an analysis of the prices charged by comparable independent networks would be

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[4] Jones Education Networks Comments at 5-7; Discovery Comments at 2-7; Rainbow Comments at 2-7; NCTA Comments at 60-64.

[5] Id.

[6] Michael A. Salinger, "The Likely Effect of the FCC's Proposed Rule for Affiliate Transactions Under Price Regulation," June, 1994, filed with the Comments of Turner Broadcasting System.

required.[7] The difficulty of this approach, as the Commission fully knows, is to find "comparable" networks.[8] Measuring cost is at least equally complicated as determinations must be made regarding an appropriate rate-of-return, the proper allocation of costs, and the treatment of subscription fees and advertising.[9]

Traditional cost-of-service concepts are not readily applicable or useful in the context of the programming industry. Cost-of-service principles have been developed to address capital-intensive, monopoly-supplied, public utility industries producing a single or discrete set of services or goods. The production of programming exhibits none of these characteristics. When applied to the programming industry, which is heavily dependent not only on labor but highly specialized labor (i.e., creative talent), return on capital concepts simply do not capture the fundamental economic risks of the business.

Vertical integration in the cable industry provides many benefits to programmers and subscribers since cable operators are an important source of revenue for programmers and have been instrumental in starting new networks.[10] These benefits have been recognized by both Congress and the Commission. In crafting

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[7] Id. at 14. The other method for estimating fair market value would be to examine the prices charged to non-affiliates, i.e., prevailing company pricing. Id. at 13-14.

[8] Id. at 14; Cost-of-Service Order, MM Docket No. 93-215 and CS Docket No. 94-28, FCC 94-39 at para. 269 (released March 30, 1994).

[9] Salinger at 14-15.

[10] Id. at 9-13.

vertical ownership rules, for example, the Commission explicitly acknowledged the positive attributes of vertical integration in the cable industry:

> First, [MSO] investment has produced a wealth of high quality cable programming services. Many of the most popular cable programming services were initiated or sustained with the help of MSO investment. Second, vertical integration between cable operators and video programming services appears to produce efficiencies in the distribution, marketing, and purchase of programming. Third, vertical integration can reduce programming costs, which in turn may reduce subscriber fees and cable rates. Fourth, vertical integration may in certain circumstances foster investment in more innovative and riskier video programming services.[11]

Affiliate transaction rules that are inappropriate, too costly and burdensome to implement will jeopardize existing and future investment in programming by the cable industry. The net result would be to defeat the recognized benefits of vertical integration, and reduce the quality of programming available to consumers.[12] A prevailing pricing rule for affiliate

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[11] Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992, Horizontal and Vertical Ownership Limits, MM Docket No. 92-264, Report and Order, 8 FCC Rcd 8565, 8594-2595 (1993).

These principles were reflected in Congress' passage of the 1992 Cable Act. See S. Rep. No. 102-92, 102d Cong., 1st Sess. 26, 27 (1991); H.R. Rep. No. 102-628, 102d Cong., 2d Sess. 41, 173 (1992) (". . . vertical integration of cable systems have led to a diversity of program offerings which had previously been unknown, . . .").

[12] TCI Comments at 49-50; Time Warner Comments at 27; NCTA Comments at 63; Discovery Comments at 2, 6; Jones Education Networks Comments at 8; Liberty Comments at 18-22.

transactions would preserve the incentives for cable operator investment in programming networks.

Moreover, Salinger explains how prevailing company pricing provides incentives for programmers to lower the price of programming to affiliated cable operators. As a result, its use should not be curtailed.[13]

The rationale for restricting the use of prevailing company pricing appears to be based on the concern that, because cable operators can pass programming costs directly through to subscribers, vertically integrated operators will use the price of programming (along with the 7.5% mark-up) to circumvent the Commission's rate regulations. As Salinger shows, however, this concern is misplaced.[14] Any added profits at the programmer level due to increases in the price of programming would in many cases be offset by the affiliated cable operator's loss of profits due to a reduction in demand for the service. While the amount of the offset will vary depending upon several factors, including the cable operator's ownership interest in the network, the operator could be made worse off by the increase in network prices. Thus, "[r]ather than pushing for an increase in the price of the network, [the cable operator] would benefit from a decrease. Under such circumstances, a prevailing pricing rule

[13] Michael A. Salinger, "The Effect of a 'Prevailing Price' Rule for Affiliate Transactions Under Price Regulation," June, 1994, filed with the Comments of Turner Broadcasting System.

[14] Id.

would induce the cable operator to try to influence the network to lower its price."[15]

The absence of concern for manipulated pricing in the area of affiliate transaction holds true for non-programming relationships as well. For example, it is not uncommon for cable operators to act as contract managers for cable systems which they partially own. Here, too, the cable system has no incentive to permit demand to be suppressed through higher than market prices. Moreover, the non-integrated owners would police such activity, even if it were attempted, since it would plainly reduce their profits.

The record on this issue, bolstered by Salinger's analysis, reveals that, if any affiliate transaction rule is at all necessary, prevailing company pricing is much easier to implement, provides incentives for continued cable operator investment in cable networks, and encourages price reductions in programming. Accordingly, the Commission should abandon its proposal to restrict the use of prevailing company pricing for affiliate transactions.

III. EXTENDING COMMON CARRIER REGULATION TO CABLE SERVICES, AND SPECIFICALLY A CABLE PRODUCTIVITY OFFSET, UNDER THE GUISE OF "REGULATORY PARITY" IS INAPPROPRIATE

Not surprisingly, the local telephone company interests nominally state their support for the establishment of "regulatory parity" between the cable and telephone industries. This argument ignores the fundamental fact that, as yet, cable

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[15] Id. at 9.

companies and telephone companies do not provide services in competition with one another, making "parity" a superficially attractive but nevertheless substantively irrelevant policy objective. The telco argument rests erroneously on the notion that these two industries are converging and, to an ever increasing degree, are competing directly with one another to provide the same services using the same technologies.[16] In support of this argument, Bell Atlantic filed a declaration by Robert G. Harris arguing for comparable price cap rules, including a productivity offset for cable.

The telcos grossly overstate the degree of competition between the cable and telephone industries and confuse the distinct services they each currently offer with, as yet, minimal overlap. With respect to telephone services, the fact remains that many states currently bar cable companies and others from providing telephone and other transmission services in competition with telephone companies. Technological advancements may well be driving these two industries closer to one another, but it is simply erroneous to state that cable companies "are a major competitor for telephone services."[17]

The local electronic distribution of switched voice and data services is today the monopoly province of the local telephone industry. Many states protect this monopoly by prohibiting any

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[16] See Comments filed by Bell Atlantic, BellSouth, and GTE.

[17] Bell Atlantic Comments at 2.

direct competition with the telco. Congress recently described the situation with unusual clarity:

> Carriers are frequently protected from competition by government barriers to entry. In fact, the Committee found that the majority of States restrict full and fair competition in the local exchange, either by statute or through public utility commission's regulations.[18]
>
> * * *
>
> State and local laws, as well as the actions of local exchange carriers, may stifle genuine competition. That is because cable companies, like other providers, may be barred from fully entering the local telephone market by State or local laws, rules, or regulations.[19]

As long as there are state statutory and regulatory barriers to entry into telephony, intermodal competition for telephone services cannot and does not exist.

Professor Harris nevertheless asserts that the same productivity offset should be applied to the cable and telephone industries. Harris argues that the same productivity offset should be applied to cable rates in order to promote economic efficiency, asserting that regulation should for both cable and telephone companies "reward efficiency-seeking behavior."[20]

Harris, however, appears to misconstrue the relationship between economic efficiency and the productivity offset. In contrast to traditional rate-of-return regulation, price cap

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[18] H. Rep. No. 103-560, 103d Cong., 2d Sess. 37 (1994).

[19] <u>Id.</u> at 41.

[20] Harris Declaration at 6.

regulation promotes efficient behavior because telephone companies are permitted to retain all, or a large part, of any cost reduction in the form of higher profits. Under price caps, however, it is not the magnitude of the productivity offset that creates this incentive. Rather, it is the fact that cost reductions need not be passed on in the form of lower prices. Because prices are (at least in theory) decoupled from costs, the same incentives for cost reduction exist regardless of the extent of the offset. Economic efficiency should not be affected by the absence or presence of a productivity offset.

This decoupling of prices and costs, which would provide the incentive for telcos to act in economically efficient ways under certain conditions,[21] is also present in the Commission's cable rate regulation scheme. As with price caps, cable systems under benchmark regulation already have maximum incentives for cost reductions since the operator's rates have been determined by the behavior of all cable systems. Adding a productivity offset to benchmark regulated cable rates does nothing to affect these incentives.

The role of the productivity offset is thus not to promote efficiency but simply to reduce subscriber rates over time. The larger the productivity offset the lower the rates. Because a productivity offset would only cause cable rates to decline, it escapes logic to argue that the telephone industry would be

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[21] Of course, the Commission should be aware that its price cap regulatory scheme is not "pure." See National Rural Telecom Association v. FCC, 988 F.2d 174 (D.C. Cir. 1993).

better able to compete with cable if cable rates were reduced. Unless the quality of cable services were to decline as well, lower cable prices would make it more difficult, not less, for the telcos to provide services in competition with cable. The Commission should be wary of the highly unusual phenomenon of competitors urging regulators to lower their competitors' prices; it is in reality merely an effort to exploit the regulatory process in ways which reduce surplus and consumer welfare.

IV. COST-OF-SERVICE REGULATION IS EXCEPTIONALLY BURDENSOME AND COSTLY FOR CABLE OPERATORS TO IMPLEMENT

Cost-of-service regulation is a time-consuming, resource-intensive, and expensive process. Despite this fact, TCI has had no choice but to proceed, in limited cases, with cost-of-service regulation given the inequities worked by the benchmarks.[22]

TCI's own experience with cost-of-service showings under the interim rules reveals the enormity of the undertaking and the magnitude of the burdens. In just two major metropolitan areas, literally hundreds of person-hours and hundreds of thousands of dollars have been and will be spent by TCI to prepare and defend cost-of-service showings before the Commission and local franchising authorities. For example, TCI's experience discloses that reorganizing accounting data into the Commission's prescribed USOA categories is a particularly costly component of the cost-of-service process.

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[22] Noted scholars caution regulators to strive for simplicity in their regulation of industries. Stephen Breyer, Regulation and Its Reform 184 (1982).

The local franchising authorities are also subject to these same burdens and costs as they are compelled to invoke their right to extend the time for review of the showings, and face the likelihood of having to retain expensive legal and accounting consultants to assist in the review of the showings. Such efforts are wasteful, particularly since more streamlined methods of regulation would easily accomplish the same objectives.

The costs incurred in cost-of-service proceedings are, in essence, dead weight loss. Certainly local and federal taxpayer monies can be better spent. Moreover, private industry resources are sapped away from surplus-producing activity, most particularly, from investing in upgrades and rebuilds which will advance NII objectives. The Commission should diligently search for ways to remove these costs and thus free up public and private resources, which can be put to better use.

V. CONCLUSION

TCI urges the Commission not to make the interim rules permanent. In particular, the Commission should abandon its proposal to restrict the use of prevailing company pricing for affiliate transactions. Further, there is no basis on the record to support the imposition of a productivity offset to cable on a nationwide basis at this time. Given the expense and burden associated with traditional cost-of-service regulation, the Commission should continue to search for ways to minimize these costs.

Respectfully submitted,

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